

**TESTIMONY OF DANIEL J. ROTH  
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**BEFORE THE SUBCOMMITTEE ON GENERAL FARM COMMODITIES  
AND RISK MANAGEMENT  
COMMITTEE ON AGRICULTURE  
U.S. HOUSE OF REPRESENTATIVES**

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My name is Daniel Roth, and I am President and Chief Executive Officer of National Futures Association. Thank you Chairman Moran and members of the Subcommittee for this opportunity to appear here today to present our views on some of the issues facing Congress as it begins the reauthorization process. NFA is the industry-wide self-regulatory organization for the U.S. futures industry. Regulation is all we do at NFA—we do not operate a marketplace and we are not a lobbying organization. As a regulator, NFA is first and foremost a customer protection organization. Our mission is to provide the futures industry with the most effective and the most efficient regulation possible.

Our approximately 4,000 Members include futures commission merchants (“FCMs”), introducing brokers (“IBs”), commodity pool operators (“CPOs”) and commodity trading advisors (“CTAs”). We also regulate approximately 54,000 registered account executives who work for our Members. As a regulator, NFA’s main responsibilities are many and varied. We establish rules and standards to ensure fair dealing with customers; we perform audits and examinations of our Members to monitor their compliance with those rules; we conduct financial surveillance to enforce compliance with NFA financial requirements; we provide arbitration and mediation of futures-related disputes; we perform trade practice and market surveillance activities for a number of exchanges; and we conduct extensive educational programs both for the investing public and for our Members. We also perform a number of regulatory functions on behalf of the CFTC, including the entire registration process—from screening applicants for fitness to taking actions to deny or revoke registrations when those fitness standards are not met. We perform these duties with a staff of approximately 235 people and a budget of over \$32 million, all of which is paid by the futures industry.

The process of self-regulation has been the subject of a great deal of criticism over the last several years. The problems in the securities industry have been well publicized to say the least and have led some, including New York Attorney General Elliot Spitzer, to label self-regulation “an abysmal failure.” Less well publicized is the tremendous track record that self-regulation has achieved in the U.S. futures industry. Since NFA began operations in 1982, volume on U.S. futures markets has increased by over 1,200%—a great testament to the innovation and value of our futures markets. What most people don’t realize is that during that same time period customer

complaints in the futures industry are down by almost 75%. In 1982 the CFTC received over 1,000 customer complaints in its reparations program. Last calendar year the CFTC received just 93 complaints. Even when you add the 158 cases filed with NFA's arbitration program, the reduction in customer complaints is dramatic.

That dramatic drop was not an accident. NFA has worked in very close partnership with the CFTC and the futures exchanges to make sure that we are allocating resources where they are most needed, that we do not duplicate each other's efforts and that precious regulatory resources are not squandered. Self-regulation, both by NFA and the futures exchanges, has served this industry very well for a very long time. That's not to say that any of us can rest on our laurels or that the self-regulatory process is perfect.

Obviously, the industry is changing rapidly, and as it changes, the conflicts of interest inherent in the self-regulatory process may change as well. As futures markets all over the world grow more and more competitive, the need to ensure that the self-regulatory process remains above the competitive fray grows too. The CFTC's job of overseeing the self-regulatory process may become more sensitive and more complicated. We have every confidence, though, that the CFTC will continue to monitor self-regulation carefully so that self-regulation in the futures industry will continue to merit the confidence that it has earned.

In the last reauthorization process, Congress made bold changes to the Commodity Exchange Act. The Commodity Futures Modernization Act rejected a highly prescriptive, outmoded approach to regulation in favor of a more flexible approach that focused regulatory protections where they were most needed. I am pleased to join the rest of the industry in noting the great success of the CFMA and the superb work of the CFTC in implementing exactly the kind of flexible regulatory approach that the CFMA envisioned. The Commission and its staff have worked to reduce unnecessary and costly regulatory burdens for every segment of the industry while preserving the highest level of customer protection. The Commission has also followed the mandate of the CFMA to maximize efficiency by delegating more day-to-day, front line regulatory responsibilities to NFA. In January 2003, the Commission delegated to NFA the authority to conduct reviews and analyses of annual financial reports filed by CPOs. Additionally, in March 2003, the CFTC authorized NFA to conduct reviews of disclosure documents for publicly-offered commodity pools. Each of these recent delegations has been performed by NFA in a high-quality and expeditious manner. In making these delegations, the Commission has been able to free up its own valuable resources to apply them to areas demanding attention.

Though the CFMA has been a great success, it failed in one of its objectives that directly impacts customer protection. In the CFMA Congress attempted to resolve the so-called Treasury Amendment issue once and for all by clarifying that the CFTC does, in fact, have jurisdiction to protect retail customers investing in foreign currency futures. The basic thrust of the CFMA in this area was that foreign currency futures with retail customers were covered by the Act unless the counterparty was an

“otherwise regulated entity,” such as a bank, a broker-dealer or an FCM. Unfortunately, as we sit here today, there is as much uncertainty over the CFTC’s authority to protect retail customers as there was five years ago. This uncertainty is clearly not what Congress intended in passing the CFMA.

The main problem stems from a decision in the Seventh Circuit Court of Appeals in a forex fraud case brought by the CFTC, the so-called Zelener case. In Zelener, the District Court found that retail customers had, in fact, been defrauded but that the CFTC had no jurisdiction because the contracts at issue were not futures. The Seventh Circuit affirmed that decision. The “rolling spot” contracts in Zelener were marketed to retail customers for purposes of speculation; they were sold on margin; they were routinely rolled over and over and held for long periods of time; and they were regularly offset so that delivery rarely, if ever, occurred. In Zelener, though, the Seventh Circuit based its decision that these were not futures contracts exclusively on the terms of the written contract itself. Because the written contract in Zelener did not include a guaranteed right of offset, the Seventh Circuit ruled that the contracts at issue were not futures.

Zelener creates the distinct possibility that, through clever draftsmanship, completely unregulated firms and individuals can sell retail customers contracts that look like futures, act like futures and are sold like futures and can do so outside the CFTC’s jurisdiction. To make matters worse, the rationale of the Zelener decision is not limited to foreign currency products. Similar contracts for unleaded gas, heating oil, agricultural products or virtually any other commodity could be sold to the public in an unregulated environment.

I recognize that Zelener is just one case, and we should not overreact to it. It’s true that the Zelener decision would allow the CFTC in other cases to present evidence that the FCM made oral representations about the customer’s right to offset. But the reality is that in most cases the sales pitch is not made by the FCM but by an unregistered, unregulated solicitor. It’s not clear to me that any court would find that the nature of the contract between the customer and the FCM was transformed into a futures contract because of oral representations made by some third party. In my opinion, trying to work our way out of the Zelener problem through future enforcement actions puts an awful lot of chips on a bet that’s no sure thing.

The bottom line is that the Zelener decision makes it much harder for the Commission to prove that contracts sold to retail customers to speculate in commodity prices are futures, makes it easier for the unscrupulous to avoid CFTC regulation and creates a real, live customer protection issue. Unsophisticated retail customers are going to be victimized by high-pressured sales pitches for futures look-alike products covering everything from foreign currencies to precious metals to heating oil and to any other commodity known to man. These retail customers are the ones who most need regulatory protection and that protection should not be stripped from them because a clever lawyer finds a loophole in the law.

It's NFA's view that Congress should address this issue. It may not be easy. The issues can be both sensitive and complex. We would want to ensure that any legislative response would not have unintended consequences. But just because it's hard doesn't mean that it can't be done. We recognize that this Subcommittee has asked the CFTC to submit specific statutory language to address this issue. NFA is working closely with the Commission and the industry to develop a specific proposal for your consideration.

Unfortunately, the Zelener decision is not the only problem we have encountered with retail forex. Since passage of the CFMA, a number of firms—that do not engage in any other regulated business—have nonetheless registered as FCMs to qualify to be an otherwise regulated entity and have become NFA Forex Dealer Members for the sole purpose of acting as counterparties in these transactions. When I testified before this Subcommittee in June 2003, NFA had 14 active Forex Dealer Members and those Members held approximately \$170 million in retail customer funds. During the last eighteen months, this retail forex business has continued to grow by leaps and bounds. Today, NFA has 28 active Forex Dealer Members holding over \$520 million in customer funds. That growth has not been problem free.

Though relatively few in number, forex dealers have accounted for 50% of our emergency enforcement actions and over 20% of our arbitration docket. I know the CFTC has been very aggressive in enforcement cases involving forex, though most of those cases have involved unregistered firms. Obviously, retail forex has consumed a good deal of resources at NFA, but we are committed to doing whatever it takes to get our job done. We have appointed a blue ribbon committee to review all of our forex rules. Just two weeks ago, our Board passed additional rules to strengthen both our financial requirements and sales practice rules regarding forex. We will continue to enforce our rules vigorously and bring actions whenever necessary to ensure compliance with our rules. Part of the problem, though, is that some firms can operate beyond our reach, in a completely unregulated environment because of a glitch in the wording of the CFMA.

As I mentioned before, the basic thrust of the CFMA was that only “otherwise regulated entities” could offer retail customers off-exchange foreign currency futures. Unfortunately, the wording of the statute only requires the counterparty to be an otherwise regulated entity. This creates the possibility that an FCM, for example, might be the counterparty but the firm that actually does the telemarketing for these products is completely unregistered and unregulated. There are literally hundreds of these unregulated firms doing telemarketing of off-exchange forex transactions to retail customers and in some instances the people making the sales pitches have been barred from the futures industry for sales practice fraud. I don't think that's what Congress intended at all and NFA would support an amendment to Section 2(c) of the Act to make clear that not only the counterparties but also the persons actually selling these products to retail customers must be “otherwise regulated entities.”

There's one more forex problem I should mention, though we are hopeful that it's a problem we can solve through NFA rules without any further legislation from Congress. Section 2(c) of the CEA could be read to allow unregulated affiliates of FCMs to act as counterparties to retail customers if the FCM makes and keeps records of the affiliates under the CEA's risk-assessment provisions. Some firms have tried to take advantage of this provision of the Act by creating "shell" FCMs. These shell FCMs do not do any futures business and they do not do any retail forex business. Their sole reason for existence seems to be to create affiliates that do retail forex business in a completely unregulated environment.

I don't think that that's what Congress had in mind. Neither does the CFTC. The Commission has a pending enforcement action against one affiliate in which it alleges, among other things, that the affiliate does not qualify under the CFTC's risk-assessment provisions. A ruling in the CFTC's favor would, in part, require FCMs with retail forex affiliates to maintain \$5 million in adjusted net capital. However, since that case may take some time to work its way through the federal court system, NFA's Board recently adopted a rule raising the minimum capital requirement for FCMs with retail forex affiliates from \$250,000 to \$5 million. We hope these efforts will solve the shell FCM problem without the need for legislative relief.

Another issue that Congress should be aware of, though we are not seeking amendments to the Act, involves the SEC's recent rulemaking that requires advisors of certain hedge funds to register under the Investment Advisers Act of 1940. Coordination among regulators has always been vital to avoid duplication of effort and the squandering of regulatory resources. With the SEC rulemaking, there's a real danger of duplication of effort regarding the CPOs and CTAs that are already regulated by the CFTC and NFA. Such duplication drains regulatory resources that are already oftentimes stretched too thin.

According to recent rankings by *Institutional Investor*, eighteen of the top 25 and 63 of the top 100 hedge fund complexes are operated by NFA Member CPOs or their affiliates. In fact, most of the prominent names in the hedge fund business are NFA Members. NFA already has extensive regulatory programs in place for all of its CPO and CTA Members, including regular audits and review of financial statements, disclosure documents and promotional material. Though we focus on futures-related activity, our review of our CPO financial records includes information on non-futures related investments. Overall, the CFTC/NFA regulation of CPOs and CTAs has been an unqualified success. CPOs and CTAs comprise 60% of NFA's membership but are named in only 20% of NFA's enforcement actions and in only 2% of customer complaints. If the SEC, the CFTC and NFA all end up regulating some of the same funds, that doesn't seem to be the smartest use of regulatory resources. We hope the CFTC and the SEC can work together to make the regulatory process as efficient as possible and we will do everything we can to help that process. Frankly, however, given our experience with security futures products, we are skeptical that regulatory efficiency can be achieved through cooperation between these agencies. We urge this Subcommittee to use its oversight function to ensure that cooperation occurs, and if you

are not satisfied with the level of cooperation, then we encourage you to consider a legislative response to this issue. We, of course, are willing to work with you in developing such a response if necessary.

One more area in which we can avoid duplication of effort would require Congressional action. The Act requires the CFTC to operate a reparations program to handle the resolution of disputes between customers and CFTC registrants. The program made a lot of sense when it was established almost 30 years ago, but the world is a much different place now. The CFTC and NFA have cracked down on sales practice fraud and NFA's arbitration program has grown and matured as an informal alternative to reparations. The impact of all these changes on the reparations program has been dramatic. In 1982, before NFA began operations, there were 1,079 cases filed with the Commission. As previously noted, last calendar year there were 93, compared with 158 arbitration cases filed at NFA. Simply stated, the reparations program has outlived its usefulness and we see no reason why the CFTC should be the only federal regulatory agency that maintains a dispute resolution forum. NFA would support an amendment to the Act to eliminate the reparations program.

In closing, let me state that NFA believes the industry and the public have benefited greatly from the enlightened regulatory approach that Congress adopted in the CFMA. We are proud of the efficiency we have brought to the regulatory process and are confident that the amendments we suggest above will further improve both customer protection and regulatory efficiency. We look forward to working with this Subcommittee and with the industry to address the issues outlined above.